No. 15815

In the United States Court of Appeals for the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

GRACE H. CUNNINGHAM, EUGENE F. CUNNINGHAM AND GRACE H. CUNNINGHAM, RESPONDENTS

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

CHARLES K. RICE,
Assistant Attorney General.
LEE A. JACKSON,
A. F. PRESCOTT,
KARL SCHMEIDLER,
Attorneys,
Department of Justice,
Washington 25, D. C.

INDEX

CITATIONS

Cases—Continued

In the United States Court of Appeals for the Ninth Circuit

No. 15815

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

GRACE H. CUNNINGHAM, EUGENE F. CUNNINGHAM AND GRACE H. CUNNINGHAM, RESPONDENTS

ON PETITIONS FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE PETITIONER

OPINION BELOW

The Tax Court's findings of fact and opinion (R. 29–53) are officially reported at 28 T. C. 670.

JURISDICTION

The petition for review in T. C. No. 55,090 (R. 147–151) involves federal income taxes for the taxable year 1946 with respect to taxpayer, Grace H. Cunningham. The petition for review in T. C. No. 55,091 (R. 151–155) involves federal income taxes for the taxable year 1952 with respect to taxpayers, Grace H. Cunningham and Eugene F. Cunningham. On August 25, 1954, the Commissioner mailed to taxpayer, Grace H. Cunningham, a notice of a defi-

ciency for the taxable year 1946 in the total amount of $6,725.59. (R. 12–15.) On August 25, 1954, the Commissioner mailed to taxpayers, Grace H. Cunningham and Eugene F. Cunningham, a notice of deficiency for the taxable year 1952 in the total amount of $9,528.54. (R. 23–26.) Within the ninety days thereafter and on October 22, 1954, taxpayers in both cases filed petitions with the Tax Court for redeterminations of the deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 3, 5, 7–15, 18–26.) The decisions of the Tax Court were entered June 26, 1957. (R. 54–55.) These cases are brought to this Court by petitions for review filed September 16, 1957. (R. 147–155.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Taxpayer leased real property to a corporation of which she was a principal stockholder and financial backer. Under the terms of the lease the corporation was to make certain improvements upon the lots, pay the taxes on the property, and transfer all right, title and interest to the improvements to the lessor at the termination of the lease. The question presented is whether the enhanced value attributable to the improvements as of the date of reversion to the lessor constitutes rental income to the lessor; and, if so, whether such income was realized in 1946, the year the improvements were erected, or in 1952, the year in which they reverted to the taxpayer.

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(b) *Exclusions From Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * *

(11) [As added by Sec. 115 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Improvements by lessee on lessor's property.*—Income, other than rent, derived by a lessor of real property upon the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee.

* * * * *

(26 U. S. C. 1952 ed., Sec. 22.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.22 (b) (11)–1. *Exclusion From Gross Income of Lessor of Real Property of*

Value of Improvements Erected by Lessee.—Income derived by a lessor of real property upon the termination, through forfeiture or otherwise, of the lease of such property and attributable to buildings erected or other improvements made by the lessee upon the leased property is excluded from gross income. However, where the facts disclose that such buildings or improvements represent in whole or in part a liquidation in kind of lease rentals, the exclusion from gross income shall not apply to the extent that such buildings or improvements represent such liquidation. The exclusion applies only with respect to the income realized by the lessor upon the termination of the lease and has no application to income, if any, in the form of rent, which may be derived by a lessor during the period of the lease and attributable to buildings erected or other improvements made by the lessee. It has no application to income which may be realized by the lessor upon the termination of the lease but not attributable to the value of such buildings or improvements. Neither does it apply to income derived by the lessor subsequent to the termination of the lease incident to the ownership of such buildings or improvements.

The provisions of this section may be illustrated by the following example:

Example. The A Corporation leased in 1935 for a period of 50 years unimproved real property to the B Corporation under a lease providing that the B Corporation erect on the leased premises an office building costing $500,000, in addition to paying the A Corporation a lease rental of $10,000 per annum beginning on the

date of completion of the improvements, the sum of $100,000 being placed in escrow for the payment of the rental. The building was completed on January 1, 1937. The lease provided that all improvements made by the lessee on the leased property would become the absolute property of the A Corporation on the termination of the lease by forfeiture or otherwise and that the lessor would become entitled on such termination to the remainder of the sum, if any, remaining in the escrow fund. The B Corporation forfeited its lease on January 1, 1942, when the improvements had a value of $100,000. Under the provisions of section 22 (b) (11), the $100,000 is excluded from gross income. The amount of $50,000 representing the remainder in the escrow fund is forfeited to the A Corporation and is included in the gross income of that taxpayer. If, in this example, the lease covered a period of only 25 years and the building upon completion had an estimated value of $75,000 as of the end of the lease term and in accordance with an option granted by the regulations the A Corporation included in gross income the sum of $3,000 for each taxable year from 1937 to 1941, both years inclusive, then there shall be excluded from gross income for the taxable year 1942 and subsequent taxable years any such amounts otherwise includible in gross income for such years and attributable to the building erected by the B Corporation, notwithstanding the exercise of such option. As to the basis of the property in the hands of the A Corporation, see section 29.113 (c)–1.

Sec. 39.22 (b) (11)–1 of Treasury Regulations 118 contains the same provisions.

STATEMENT

The relevant facts may be stated as follows:

Taxpayers, Grace H. Cunningham and Eugene F. Cunningham, are husband and wife. Grace H. Cunningham filed an individual income tax return for 1946. For 1952, she and her husband filed a joint return. (R. 30.)

In 1928, Grace H. Cunningham started a steel manufacturing enterprise which was incorporated in 1936 as the American Manufacturing Company, Inc. She has been one of the principal owners of its stock and its general manager and financial backer. Her brother has been its president and executive head, and her husband, Eugene F. Cunningham, has been its vice president and a member of its board of directors. This company manufactures heavy machinery. (R. 31.)

The property of the American Manufacturing Company is situated in block 2103 of the City of Tacoma. Immediately to the east of this property, and separated from it by an alley 40 feet in width, are situated lots 7 to 12 of block 2103, which in 1936 were owned by other persons. At that time those lots were not level, in some places being as much as 30 to 40 feet below grade, and had little usable surface. For many years they had constituted a dumping ground for rubbish and scrap. In 1936, American Manufacturing Company under an oral agreement with the owners acquired the right to use these lots for open storage of steel and other materials and to make such fills as

might be necessary. By 1943, or 1944, the lots had been filled so as to become usable over their entire area. The American Manufacturing Company did not, up to that time, pay any rent or taxes for use of the lots. For a portion of 1943, it paid $10 per month for the use of lots 8 to 12 under an oral agreement, after having installed an annealing oven on a portion of lots 8 to 12. The American Manufacturing Company agreed at that time to remove the annealing oven as soon as its use was terminated. (R. 31–32.)

In 1943, the American Manufacturing Company erected a craneway on lot 9 of block 2102 to be used for the moving of heavy equipment. The dimensions of lot 9 are 25 feet by 120 feet. A slab of cement 25 feet in width and approximately 60 feet in length was laid down and the craneway was then erected of wood with columns running the full length of 120 feet. (R. 32.)

The company was still in need of additional working space for steel cutting equipment. In October, 1944, the company owed a bank $41,000. On January 1, 1946, it owed banks about $172,000 and Cunningham Steel Foundry (owned by Eugene F. Cunningham) $25,000. At the end of 1946 it owed banks about $184,000. Grace H. Cunningham was endorser and guarantor of the bank loans. (R. 32.)

On October 26, 1944, Grace H. Cunningham purchased lots 7 to 12 of block 2102 for a price of $8,000. At that time the American Manufacturing Company was expanding rapidly. Immediately following this purchase the American Manufacturing Company at

461775—58——2

its own cost placed an adequate roof over the superstructure of the craneway and also enclosed the entire south side of the craneway, 120 feet, with large windows supported by hollow cement tile blocks. This constituted the cheapest type of construction permitted by the building code of the City of Tacoma. (R. 32–33.)

In November 1945, Eugene F. Cunningham desired to erect a warehouse building on lots 4, 5, and 6 of block 2102. Grace H. Cunningham had no interest in such lots nor in the building to be constructed thereon. Eugene F. Cunningham needed more area for the contemplated building and purchased lot 7 of block 2102 from his wife for $1,333.33. He then erected a cement warehouse building 120 feet long and 100 feet wide known as the Graybar Building, which was ready for occupancy by May, 1946. The southerly wall of the building constituted the dividing line between lots 7 and 8. (R. 33.)

Grace H. Cunningham, being the largest stockholder and manager of American Manufacturing Company, was desirous of permitting the company to expand its business and to obtain necessary room by changing the craneway into a complete structure. In the latter part of December, 1945, she entered into an oral lease with the American Manufacturing Company covering lots 8 to 12 of block 2102. It was agreed that the American Manufacturing Company could use lot 8 which adjoined the Graybar Building and lot 9 for the purpose of enclosing both lots 8 and 9 as one large area 50 feet by 120 feet, this to be done by closing the two 50-foot ends by

use of large doors and using the south wall of the Graybar Building as the north wall of the enclosure. (R. 33–34.) The terms of this oral lease are substantially set forth in the minutes of a meeting of the board of directors of the American Manufacturing Company held on December 15, 1945, which contain the following (R. 34–35):

> The President also announced that said Grace H. Cunningham was desirous of leasing said property to the American Manufacturing Company, Inc., on the following basis:
>
> That the American Manufacturing Company would construct a building on said property at its own expense; would pay all the taxes, and at the end of a 6 year period, said lease would be terminated and the building on the property would revert to the owner of the real property, Grace H. Cunningham. That there would be no rent paid for said lease but that the consideration for the lease was the transfer of the building to Grace H. Cunningham at the end of the term of the lease. Therefore, after full discussion having been had, the following resolution was unanimously adopted:
>
> "Be It Resolved, that the proper officers of the American Manufacturing Company, Inc., be instructed to prepare the proper instruments to lease from Grace H. Cunningham, Lots 8, 9, 10, 11 and 12, Block 2102, Tacoma, Land Company, Fifth Addition, Tacoma, Washington, for a period of six years commencing with the 2nd day of January, 1946. That the terms and conditions of said lease be such that the consideration for said lease would be the transfer of any and all interests that

> the American Manufacturing Company, Inc., had in the building to be constructed on the premises to be transferred to Grace H. Cunningham. That American Manufacturing Company, Inc., would immediately commence construction of a building on said premises of the approximate value of $25,000.00. That the proper officers of the American Manufacturing Company, Inc., also be instructed to pay the taxes on said property for the term of the lease."

The lease was later reduced to writing in a written lease dated March 17, 1947. (R. 35.) Such lease provides for a term of 6 years from January 2, 1946, to January 2, 1952, and recited (R. 35–36):

> The consideration for said lease being that the lessee will pay taxes on the above-described property for a period of six years and will transfer, at the end of the period of the lease, all right, title and interest which said lessee has in a building which lessee has constructed and paid for on the above-described property.
>
> * * * * *
>
> And at the expiration of said term, the said lessee will quit and surrender the said premises in good state and condition as they now are (ordinary wear and damage by the elements or fire excepted).

Prior to January 1, 1946, the American Manufacturing Company had expended $2,800 for roofing of the craneway on lot 9 and the enclosure of the south wall with hollow tile and glass windows, and $2,755 for grading and paving the alley. Subsequent to the effective date of the lease, January 2, 1946,

the American Manufacturing Company expended $11,097 as cost of improvements which, pursuant to the lease, were to revert to Grace H. Cunningham at the end of the lease period. Another craneway was built on lot 8, next to the Graybar Building, a floor was laid, a roof was constructed over lot 8 (resulting in a roof over both lots 8 and 9), and doors were installed at the ends of the structure located on both lots 8 and 9. The improvements placed upon the property by the American Manufacturing Company which under the terms of the lease were to revert to the taxpayer are improvements attached to the realty. (R. 36.)

On March 29, 1946, Eugene F. Cunningham, as first party, and his wife and the American Manufacturing Company, Inc., as second parties, entered into a party wall agreement in which it was recited that the parties are the owners of adjoining pieces of property, and it was agreed that the south wall of the Graybar Building should thereafter be the common property of the parties to the agreement, and that the covenants contained in the agreement should run with the land. Since the Graybar Building was not as tall as the building on the lots of Grace H. Cunningham, it was necessary to extend the height of the wall by several feet. The party wall was completed in 1946, prior to the execution of the party wall agreement on March 29, 1946. The American Manufacturing Company paid $4,734 in connection with the party wall. The party wall agreement was made as a part of or in connection with the oral lease. (R. 36–37.)

On January 2, 1952, the American Manufacturing Company released all right, title, and interest in and to the improvements, to Grace H. Cunningham. This release did not change or purport to change the rights of the parties under the party wall agreement. (R. 37.)

On January 14, 1952, the taxpayers, as husband and wife and as a community, executed a new lease with the American Manufacturing Company covering lots 8 and 9 and the east 40 feet of lot 10 in block 2102, together with improvements for a period of 10 years from and after January 1, 1952. The lessee agreed to pay $10 per month and all taxes of every kind against the property and any and all other expenses of any kind or character incident to the occupation or maintenance of the premises. The lessee agreed that any additions or repairs or improvements placed upon the building should, at the expiration of the lease, become the property of the lessors. It further agreed to keep the building fully insured in an amount satisfactory to the lessors. (R. 37.)

Since January 1, 1952, the American Manufacturing Company has paid rent of $10 per month, together with taxes, for lots 8 and 9 and the east 40 feet of lot 10 of block 2102. (R. 38.)

The only specified cash rent as such that was ever paid up to January 1, 1952, for the use of any part of the properties was $10 per month for a portion of the year 1943, which was prior to the time Grace H. Cunningham purchased lots 8 to 12. (R. 38.)

The American Manufacturing Company capitalized the total cost of improvements on these lots

on its books and corporation income tax returns at $21,904.33, and claimed a depreciation deduction of one-sixth of that amount in each of the taxable years 1946 to 1951, inclusive. (R. 38.)

The assessed valuation of the lots exclusive of improvements, as determined by the county assessor for the various years involved in the first lease period was $2,800 and the average rate of taxation during such period was roughly 6.5 percent. The average annual tax during such period, exclusive of improvements, was $182. The taxes on lots 8 to 12, inclusive, including improvements, for the years 1946 to 1950, were as follows:

1946, paid in 1947	$218.11
1947, paid in 1948	677.11
1948, paid in 1949	588.46
1949, paid in 1950	689.63
1950, paid in 1951	620.71

The annual cost of insurance was $66.66. The policy does not protect the taxpayer nor does she carry insurance on the property. (R. 38–39.)

In determining the deficiency of Grace H. Cunningham, for the year 1946, the Commissioner added to her reported taxable income the amount of $14,714.60 as rental income, stating that the cost of improvements placed in 1946 by the lessee upon lots 8, 9, 10, 11 and 12 constituted taxable income to her in that year as lessor, to the extent of the present fair market value of such improvements, subject to the lease, which would revert to her at the end of the six year term. (R. 39.) The Commissioner's

computation of the amount of $14,714.60 was as follows (R. 39):

Cost of improvements—1946	$21,904.33
Less: Depreciation for six-year term of lease at 2½ percent per year	3,285.66
Depreciated or adjusted basis Jan. 2, 1952	18,618.67
Present value of $1.00 payable at end of six years at 4 percent	.790314
Fair market value of improvements January 2, 1946	14,714.60

In determining deficiency for the year 1952 of Grace H. Cunningham and Eugene F. Cunningham, the Commissioner added to their reported taxable income the amount of $18,071.06 as rental income, stating that the cost of improvements constituted taxable income to them in 1952, to the extent of the fair market value of such improvements, when they reverted to them at the end of the six year term. (R. 39–40.) The amount of $18,071.06 was computed by the Commissioner as follows (R. 40):

Cost of improvements—1946	$21,904.33
Less: Depreciation for six-year term of lease at 2½ percent per year	3,285.66
Fair market value of improvements Jan. 2, 1952	18,618.67
Less: Depreciation for 1952 on above improvements	547.61
Increase in income	18,071.06

Included in the above cost of $21,904.33 is the amount of $4,734 paid by the American Manufacturing Company to constitute the south wall of the Graybar Building, a party wall. Also included is the amount of $2,755, the cost of construction and hard-surfacing of the alley. The Tax Court held that this latter amount did not constitute a proper part of the cost of the building. (R. 40.)

The Tax Court concluded (R. 40–53) that the parties did not intend that the value attributable to the improvements should constitute rent and stated that it follows that they (R. 53) "did not derive [taxable] income attributable to such improvements either in 1946, or in 1952."

STATEMENT OF POINTS TO BE URGED

On appeal the United States urges and relies upon the points originally stated by it (R. 158–159), which are as follows:

With respect to the appeal of T. C. Docket No. 55,091, the Commissioner contends:

1. The Tax Court erred as a matter of law in failing to hold that taxpayers, Eugene F. Cunningham and Grace H. Cunningham, realized taxable income in 1952 equal to the then fair market value of improvements constructed by the lessee in 1946 upon the property involved subject to a six-year lease and which reverted to taxpayers in 1952 at the termination of the lease.

2. The Tax Court's finding that the value of the improvements made by the lessee did not represent rent upon termination of the lease in 1952 is clearly erroneous.

3. The Tax Court erred in failing to find the amount of the gross income received in 1952 by taxpayers, Eugene F. Cunningham and Grace H. Cunningham, attributable to the improvements placed upon the property by the lessee.

461775—58——3

The Commissioner alternatively contends, with respect to the appeal of T. C. Docket No. 55,090, as follows:

1. The Tax Court erred as a matter of law in failing to hold that taxpayer, Grace H. Cunningham, realized taxable income in 1946, as lessor, equal to the January 2, 1946, value of improvements constructed by the lessee, which improvements, pursuant to the lease, were to and did revert to taxpayer at the end of the 6-year term.

2. The Tax Court's finding that the value of the improvements made by the lessee did not represent rent at the time of construction in 1946 is clearly erroneous.

3. The Tax Court erred in failing to find the amount of the gross income received in 1946 by taxpayer, Grace H. Cunningham, attributable to the improvements placed upon the property by the lessee.

SUMMARY OF ARGUMENT

Where the consideration for a lease is that the lessee shall erect a building or erect improvements on the leased property, and the building or improvements whose life extends beyond the term of the lease are to revert to the lessor at the end of the term, the lessor receives income under Section 22 (a) of the 1939 Code to the extent of the enhanced value of the property attributable to the building or improvements which revert to the lessor. Cf. *Helvering* v. *Bruun,* 309 U. S. 461.

After the decision of *Helvering* v. *Bruun, supra,* in which it was held that a lessor had received a windfall upon reversion of improvements, which without

forfeiture would *not* have outlasted the lease term, Congress in 1942 amended the 1939 Code to limit the recognition of income on termination of a lease from the enhancement of the value of property resulting from the erection of a building or improvements to that which constitutes rent.

Rent is that which an owner receives for the use or occupancy of real property. Where the sole specified consideration for occupancy is the construction of a building whose life extends beyond the term of the lease, which reverts to the lessor at the termination of the lease, the lessor as a matter of law receives the building for the occupancy of the premises as rent. When the building here was erected, though subject to the lease, the real estate was enhanced in value which enhancement either represented a prepayment to the lessor of rental or a prospective right to receive the building as rental at the expiration of the lease. Thus, there is no room for the intent of the lessor, and the Tax Court erred in not concluding that this enhanced value constituted rent as a matter of law.

The Tax Court not only erred as a matter of law in finding that the enhanced value of the premises due to the erection of the building did not constitute rent, but its finding was also clearly erroneous. Taxpayer was not only the principal stockholder, but was an officer of the corporation which resolved that the building would be erected, and that it would revert to the taxpayer, and was a signatory to the lease which stated that the reversion to her of the building was the consideration for the lease. Her tes-

timony as to intent, in the circumstances here, can but be directed at a legal change of a written instrument. Further, the asserted intent is not only contrary to the terms of the lease, but can have but one purpose—that is, to save taxes. If the testimony is to be considered at all, it must be considered with the fact that the lease was clearly not an arm's length transaction. If such an intent is to govern, then a taxpayer, as here, may contract with his controlled corporation to erect a valuable building upon his premises, amortize it fully for the benefit of the corporation over a period of six years, and then turn it over to him tax free. This, even where the lease specifically provides that the building will be consideration for the corporation's occupancy. We submit that Congress, in amending the statute after the decision in the *Bruun* case, had no such intention—that the purpose of the amendment was to prevent taxation of a windfall, where the life of the improvements and the terms of the lease show that the improvements were not intended as rental.

While we contend that the income was realized in 1952 when the building reverted to taxpayer under the facts of this case it is possible that income might have been realized in 1946 when the building was erected. Here the term of the lease is six years, and no question has been raised that the building will not outlast the term. Therefore it may be said that taxpayer's property was enhanced in value immediately upon erection of the building, and that the enhanced value represented a prepayment to the lessor of a portion of the rental.

The Tax Court did not make any finding with respect to the value attributable to the building either in 1946 or in 1952. Hence, we submit, in the event of a reversal this case should be remanded to the Tax Court with direction to find the enhanced value of the leased property attributable to the building erected in the year the income was realized.

ARGUMENT

The Tax Court erred in failing to hold that the fair market value of improvements erected by a lessee upon taxpayer's real estate and reverting to taxpayer in consideration for a lease of 6 years constitutes taxable income to her as rent

A. The law

Where the consideration for a lease is that the lessee shall erect a building or construct improvements on the leased property and the building or improvements shall revert to the lessor at the termination of the lease, the lessor receives income under Section 22 (a) of the 1939 Code, *supra,* to the extent of the enhanced value of the property attributable to the building or improvements which reverted to the lessor.

In 1940, the Supreme Court decided *Helvering* v. *Bruun,* 309 U. S. 461. In that case the owner leased a lot of land and the building standing on it for a term of 99 years. In accordance with the provisions of the lease, 14 years after the lease had been executed the lessee demolished and removed the existing building and constructed a new one which had a useful life of not more than 50 years. About 4 years after the erection of the new building the lease was cancelled for default in payment of rent and taxes and the owner regained possession of the land and build-

ing constructed by the lessee. The Commissioner included in the owner's income the difference between the fair market value of the new building and the undepreciated cost of the old which had been removed. The Supreme Court upheld the Commissioner's determination, holding (p. 469):

> While it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction. The fact that the gain is a portion of the value of property received by the taxpayer in the transaction does negative its realization.
>
> Here, as a result of a business transaction, the respondent received back his land with a new building on it, which added an ascertainable amount to its value. It is not necessary to recognition of taxable gain that he should be able to sever the improvement begetting the gain from his original capital. If that were necessary, no income could arise from the exchange of property; whereas such gain has always been recognized as realized taxable gain.

There was no question in *Bruun* but that the taxpayer therein, the lessor, derived gain.[1] It is clear from the opinion that this gain was treated as a windfall and not as rental. This is the reason why Con-

[1] The history of this question is treated at some length in *Bruun* and in *Hewitt Realty Co.* v. *Commissioner*, **76 F. 2d** 880 (C. A. 2d).

gress 2 years later changed the statute, and the amendment involved here must be construed in this light.

Congress, by Section 115 of the Revenue Act of 1942, c. 619, 56 Stat. 798, added Section 22 (b) (11) to the 1939 Code to limit the recognition of income on termination of the lease to that which constitutes rent.[2] The Committee Reports explain this as follows (H. Rep. No. 2333, 77th Cong., 2d Sess., p. 69 (1942–2 Cum. Bull. 372, 425); S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 78–79 (1942–2 Cum. Bull. 504, 564–565)):

> In *Helvering* v. *Bruun* (309 U. S. 461 (1940) * * *) it was held that building or other improvements made by a lessee constitute income to the lessor to the extent of the value of such improvements at the time the lease is forfeited and the lessor secures control and possession of the property. Your committee believes it advisable to exclude (except in cases where such improvements represent a liquidation in kind of lease rentals) from the gross income of the lessor income attributable to such improvements. Such exclusion from gross income of the lessor does not mean that the enhancement in value in the hands of the lessor will not be ultimately taxed. By reason of the fact that the gross income attributable to the value of the improvements is not recognized, the

[2] The Revenue Act of 1942 also added subsection (c) to Section 113 to provide that the basis of real property to the lessor should not be increased or diminished on account of payments received by the lessor which are excludable from income under Section 22 (b) (11).

basis of the property in the hands of the lessor will not be increased by such item.

* * * * *

Section 19.22 (b) (11)–1 was added to Treasury Regulations 103 by T. D. 5238, 143–1 Cum. Bull. 79, to conform to the 1942 statutory change. This provision, as later promulgated in Treasury Regulations 111, Section 29.22 (b) (11)–1, *supra,* is, in part, as follows:

> Sec. 29.22 (b) (11)–1. *Exclusion From Gross Income of Lessor of Real Property of Value of Improvements Erected by Lessee.*— Income derived by a lessor of real property upon the termination, through forfeiture or otherwise, of the lease of such property and attributable to buildings erected or other improvements made by the lessee upon the leased property is excluded from gross income. However, where the facts disclose that such buildings or improvements represent in whole or in part a liquidation in kind of lease rentals, the exclusion from gross income shall not apply to the extent that such building or improvements represent such liquidation. The exclusion applies only with respect to the income realized by the lessor upon the termination of the lease and has no application to income, if any, in the form of rent, which may be derived by a lessor during the period of the lease and attributable to buildings erected or other improvements made by the lessee. It has no application to income which may be realized by the lessor upon the termination of the lease but not attributable to the value of such buildings or improvements. Neither does

> it apply to income derived by the lessor subsequent to the termination of the lease incident to the ownership of such buildings or improvements.
>
> * * * * *

See also Section 39.22 (b) (11)–1 of Treasury Regulations 118, promulgated under the 1939 Code. This provision is currently in effect in Section 109 of the 1954 Code and Section 1.109–1 of Treasury Regulations on Income Tax, promulgated under the 1954 Code.

Thus, it is clear that the 1942 statutory amendment did not have any application to income representing a liquidation in kind of lease rentals attributable to improvements erected by a lessee, but was enacted to prevent the taxation of income which represented a windfall from cancellation of a lease. Thus, the question presented here is whether the enhanced value attributable to the improvements constitutes rent.

B. The Tax Court erred as a matter of law in not holding the enhanced value constituted rent

The Tax Court concluded (R. 53) that the parties to the lease "did not intend that the value of the improvements should constitute rent" and concluded "that the value of such improvements made by the lessee did not represent rent" based upon its finding that the parties did not so intend. We submit that the Tax Court erred as a matter of law in reaching this conclusion.

Rent represents payment for the use or occupation of real property and may be paid either in the form

of cash, or in the form of provisions, chattels, services or other property. Also, it may be paid ratably or in lump sums. No particular words are necessary to create an obligation to pay rent or the form of the rent to be paid so long as it appears that there was an agreement or understanding between the owner and the occupant of premises that some consideration was to be given for the use or occupancy of the premises. *M. E. Blatt Co.* v. *United States,* 305 U. S. 267; *Duffy* v. *Central R. R.,* 268 U. S. 55; *In re Roth & Appel,* 181 Fed. 667 (C. A. 2d); *In re Mullings Clothing Co.,* 230 Fed. 681 (Conn.), certiorari denied *sub nom. Chamberlin* v. *Mullings,* 243 U. S. 635; *In re Schulte-United,* 2 F. Supp. 285, 286 (S. D. N. Y.). See *Logan Coal & Timber Ass'n* v. *Helvering,* 122 F. 2d 848, 850 (C. A. 3d); *In re Bonwit, Lennon & Co.,* 36 F. Supp. 97, 100–102 (Md.). See also 32 Am. Jur. (1955), Landlord and Tenant, pp. 347–349, 362–363.

Where in addition to the provision for the erection of a building the lessee pays cash rental, there is room for the question of whether the building is to be considered rental. However, where, as here, the sole specified consideration for occupancy (except the payment of taxes) is "construction of a building on said premises of the approximate value of $25,000.00" (R. 35) whose life (40 years) extends beyond the term of the 6-year lease, with no renewal clause, we submit, there is no room for the intent of the owner to whom the lease carefully provides it will revert. Clearly, under such facts the owner receives for the occupancy of the premises, a valuable building, either at

the beginning or at the end of the lease. When the building was erected, though subject to the lease, the real estate was enhanced in value and either "represented a prepayment to the lessor of * * * rental", *Miller* v. *Gearin,* 258 Fed. 225, 226,[3] or a prospective right to receive the building which was actually received, at the expiration of the lease term with untrammeled right to dispose of it or use it in any manner she saw fit (cf. *M. E. Blatt Co.* v. *United States,* 305 U. S. 267, 280), giving rise to a taxable gain.

It is difficult to see how it is possible to "intend" that the enhanced value attributable to a building which comes to the lessor as sole consideration for the occupancy of his premises can be other than rent. In the present case it is clear that the consideration for occupancy of the premises over the 6-year period was the erection of the building and its reversion to the lessor. The lease provided that; and so did the corporate resolution authorizing rental of the property. Under these circumstances, as a matter of law, the enhanced value attributable to the building which reverted to taxpayers constituted rent.

C. The Tax Court's findings are clearly erroneous

The Tax Court ignored the factor that the enhanced value attributable to the building could constitute rent as a matter of law, but limited its decision solely

---

[3] The lease in *Gearin* did not as here require the lessee to erect a building. The oral lease here and the corporate resolution were made in 1945. (R. 60–61, 70–72.) It was not until March 17, 1947, after the erection of the building, that the written lease was executed. (R. 67–70.)

to the intention of the parties to the lease. The Tax Court found (R. 40, 53) that the parties did not intend the improvements should constitute rent and concluded from this that taxpayers did not receive any rental income from the lease. We submit that the Tax Court erred in this respect.

Where, as here, the question of intent will have an effect only taxwise, the close relationship of the parties cannot be overlooked. If facts which show that the transaction was not at arm's length are to be considered in determining the intent of the parties, the tax consequences which flow from such a transaction should also be considered.

The effect of the Tax Court's decision is to permit the lessee-corporation to deduct the entire cost of the building over the 6-year period of the lease rather than over the useful life of the building (which deduction inures both to the benefit of the corporation and to taxpayer as principal stockholder of the corporation) and yet charge taxpayer with no income upon receipt of the building at the expiration of the lease, even though the lease instrument states that the building is the consideration for which the lease is given.

Even if it were correct for the Tax Court to have relied solely upon the intention of the parties, we submit that the finding that the parties did not intend the building to constitute rent is clearly erroneous.

The Tax Court relied primarily (R. 52–53) upon the testimony of taxpayers that there was no intention to charge rent (R. 97–98, 132), and that the improvements did not have any value except for use by

the corporation or by someone in a similar business (R. 104–105, 111–113, 134, 136–137). We submit that reliance upon this testimony is clearly erroneous.

Since taxpayer was a signatory to the lease which stated that the reversion to her of the building was the consideration for the lease, her testimony to the contrary, directed at a change of the legal effect of a written instrument, should not be accorded any weight. *Jurs.* v. *Commissioner,* 147 F. 2d 805 (C. A. 9th); *Joe Balestrieri & Co.* v. *Commissioner,* 177 F. 2d 867, 873–875 (C. A. 9th); *Campbell* v. *Lake,* 220 F. 2d 341 (C. A. 5th); *Funk* v. *Commissioner,* 185 F. 2d 127, 129 (C. A. 3d); *Pugh* v. *Commissioner,* 49 F. 2d 76, 79 (C. A. 5th), certiorari denied, 284 U. S. 642. Cf. *Particelli* v. *Commissioner,* 212 F. 2d 498 (C. A. 9th).

Further, as we have pointed out, *supra,* taxpayer's testimony that (R. 52) "she had no intention of charging rent" is contradicted by the terms of the lease, which states (R. 68) that "the consideration for said lease being that the lessee will pay taxes on the above-described property for a period of six years and will transfer, at the end of the period of the lease, all right, title and interest which said lessee has in a building which lessee has constructed and paid for on the above-described property", by the terms of the corporate resolution (R. 70–72), and by the fact that she actually did receive the reversion of the building.

Also, the circumstances leading up to the signing of the lease contradict taxpayer's testimony and the Tax Court's finding that she did not intend to charge any rent for the lease. Both taxpayers testified that

Mrs. Cunningham purchased the vacant lots to enable the corporation to expand its business. (R. 95, 126.) If a corporation purchases lots, and constructs a building on its own lots, the corporation would be required to depreciate the building over its useful life, and not merely over the period of a short-term lease. By having its principal stockholder purchase the land and lease it the corporation would have the advantage of being able to deduct the entire cost of the building over the shorter term of the lease. (See R. 101, 105, 108–109.) Thus, a corporation would be able to recoup its entire costs of the building over a few years, and at the end of the lease term its principle stockholder would receive a building having value at no cost to him and free from tax.

Additionally, since taxpayer was the controlling stockholder of the corporation and its manager, and she negotiated the lease with her brother (R. 57–58, 61, 131), there does not appear to have been any arms-length bargaining between her and the corporation. By such an instance a lessor would profit as the principal stockholder of his lessee-corporation, by having it write off its cost in 6 years. Also, by having the corporation's directors state in the minutes that no rent was charged for the lease, the lessor would be able to avoid having the value of the building constitute rent to him.

Secondly, the taxpayers' testimony and the Tax Court's reliance upon the statement that the improvements lacked any value in the hands of taxpayers appears to be clearly wrong. The corporation continued to remain in business at the same place after

the initial 6-year lease expired. (R. 63–64, 76–77, 136.) Further, its sales expanded during the years 1952 through 1955. (R. 65–66.) Accordingly, it would appear that the corporation continued to have a need for the lots and building it had erected, which is substantiated by the fact that within 2 weeks after the 6-year lease terminated, the corporation and taxpayers entered into a new lease for only the two and a half lots with the building erected on it, rather than for five lots as before, for 10 additional years. (R. 76–79.)

The Tax Court made no findings that the building lacked value to the lessor. Indeed it assumed it had value. In any event it is clear that the building did have value. Taxpayers testified (R. 113, 136) that the building was a one type building. Even assuming taxpayers' testimony, nevertheless the building was admirably situated for use by the lessee-corporation. This is borne out by the increase in sales by the corporation after its erection and use of the building. (R. 65–66.) Certainly in an arm's length transaction taxpayers, after reversion, would have received a rental commensurate with the corporation's desire to occupy the premises. Further, the premises with the building would be of value to third persons, knowing as the Tax Court did that the corporation needed it so badly.[4]

Taxpayers' can find no comfort in *M. E. Blatt Co.* v. *United States,* 305 U. S. 267. There the lessor

[4] Taxpayers' testimony that the corporation was not able to purchase the lots is not relevant here, and any reliance upon such testimony by the Tax Court would be clearly erroneous.

leased property for use as a moving picture theater for a term of 10 years. At its own cost the lessor agreed to make certain alterations, and the lessee agreed to install motion picture equipment, theater seats and other fixtures, furniture and equipment at its cost. All improvements were completed before the lessee took possession. The total cost of all improvements was $114,468.77; the lessor paid $73,794.47; the lessee paid the balance of $40,674.30. The estimated depreciated value at the termination of the lease of the alterations and improvements paid for by the lessee was agreed to as $17,423.14. For the year in which the improvements were completed the Commissioner added to the income of the lessor $1,742.31, or one-tenth of the depreciated cost. The Court stated (pp. 276-277):

> We are not called on to decide whether under any lease or in any circumstances, income is received by lessor by reason of improvements made by lessee, nor to choose, for general approval or condemnation, any of the theories expounded by the United States. Concretely, the question presented is whether, under the lease here involved, one-tenth of what the commissioner and taxpayer call and agree to be "estimated depreciated value," as of the end of the term, was income to petitioner in the first year of the term. * * *
>
> There is nothing in the findings to suggest that cost of any improvements made by lessee was rent or an expenditure not properly to be attributed to its capital or maintenance account as distinguished from operating expense. While the lease required it to make improve-

> ments necessary for successful operation, no item was specified, nor the time or amount of any expenditure. The requirement was one making for success of the business to be done on the leased premises. * * * The facts found are clearly not sufficient to sustain the lower court's holding to the effect that the making of improvements by lessee was payment of rent.

The Court went on to hold (pp. 278–279):

> The findings fail to disclose any basis of value on which to lay an income tax or the time of realization of taxable gain, if any there was. The figures made by the commissioner are not defined. The findings do not show whether they are intended to represent value of improvements if removed or the amount attributable to them as a part of the building.
>
> * * * * *
>
> Granting that the improvements increased the value of the building, that enhancement is not realized income of lessor. So far as concerns taxable income, the value of the improvements is not distinguishable from excess, if any there may be, of value over cost of improvements made by lessor. Each was an addition to capital; not income within the meaning of the statute. * * *

In *Blatt* the only year in issue was the year in which the improvements were completed. Thus, the Supreme Court did not have before it the question whether the enhanced value of the property attributable to the improvements was income in the year in which they reverted to the lessor. The Court there

stressed the fact that many of the fixtures were completely depreciable over the term of the lease, and that apparently the others by the end of the term would prove to be junk. Here the Tax Court has, as it must, assumed a value at the end of the term. In holding that no income was received in the year in which the improvements were completed the Court stated (p. 280):

> But, assuming that at some time value of the improvements would be income of lessor, it cannot be reasonably assigned to the year in which they were installed. The commissioner found that at the end of the term some would be worthless and excluded them. He also excluded depreciation of other items. These exclusions imply that elements which will not outlast lessee's right to use are not at any time income of lessor. The inclusion of the remaining value is to hold that petitioner's right to have them as a part of the building at expiration of lease constitutes income in the first year of the term in an amount equal to their estimated value at the end of the term without any deduction to obtain present worth as of date of installation. It may be assumed that, subject to the lease, lessor, became owner of the improvements at the time they were made. But it had no right to use or dispose of them during the term. Mere acquisition of that sort did not amount to contemporaneous realization of gain within the meaning of the statute.

The facts of the present case, on the other hand, clearly show that the terms of the lease are that the lessee (R. 72) "would immediately commence construc-

tion of a building on said premises of the approximate value of $25,000.00"; and that (R. 68, 71, 72) the consideration for the lease would be the transfer of all interest in the building at the termination of the lease to the lessor, after a 6-year period, a period much shorter than the life of the building. These facts may give rise to income at the beginning of the term. Certainly they show an enhanced value at the end of the term. The year in which this enhanced value was realized is discussed below.

D. The year in which the gain was realized

While we contend that the income was realized in the year 1952 (*Helvering* v. *Bruun, supra; Lewis* v. *Pope Estate Co.,* 116 F. 2d 328 (C. A. 9th), certiorari denied, 314 U. S. 630; *Greenwood Packing Plant* v. *Commissioner,* 131 F. 2d 787 (C. A. 4th); *Trask* v. *Hoey,* 177 F. 2d 940 (C. A. 2d). See *Helvering* v. *Wood,* 309 U. S. 637, reversing *per curiam,* 107 F. 2d 869 (C. A. 7th); *Helvering* v. *Center Investment Co.,* 309 U. S. 639, reversing *per curiam,* 108 F. 2d 190 (C. A. 9th); see also Section 19.22 (a)–13 of Treasury Regulations 103, added by T. D. 4980, 1940–2 Cum. Bull. 42) we contend in the alternative that the gain was realized in 1946. We are not unmindful of this Court's decision in *Lewis* v. *Pope Estate Co., supra.* However, the facts in the instant case differ so substantially from *Pope* and other cases holding that no income is realized by a lessor at the time a building is erected by a lessee that we feel it possible that a different result might be reached here. In *Pope* the lease was for a period of 50 years, in *Center Investment Co.* for a period of over 97 years,

in *Bruun* for a period of 99 years, in *Hewitt Realty Co.* v. *Commissioner,* 76 F. 2d 880 (C. A. 2d), for 21 years with contingent option to renew for three successive like periods. In *Blatt* while the lease was for a period of only 10 years, the lessee's improvements were not a building but fixtures whose useful life depreciated during the term of the lease from 30 percent to 66 percent. In fact, in *Blatt,* the Commissioner found that some of the lessee's improvements would be exhausted at the end of the term. Items, building or fixtures which will not outlast lessee's right to use are not "at any time income of a lessor."

Such is not the fact here. The term of the lease is 6 years. No question has been raised that the building will not outlast the term. The Commissioner has determined it is depreciable at 2½ percent—has a life of 40 years. This has not been combatted with competent testimony. Can it be said that taxpayer's property was not enhanced in value immediately upon erection of the building—that taxpayer did not immediately acquire, for consideration of occupancy, an enhanced value, realized income. That "at that time it represented a prepayment to the lessor of a portion of the rental * * *" (*Miller* v. *Gearin, supra,* p. 226).

It is true that this enhanced value probably was included in and was not separable from the leased premises. It is also true that in *Blatt* it was held where inseparable no income was then realized. But, this was held on the facts of that case, citing *Hewitt* and cases therein cited. However, the Supreme Court in its later decision in *Bruun* not only overruled

Hewitt but limited *Blatt* to "the circumstances disclosed" in that case; and made it quite clear that it was holding that income was realized even on the assumption that, and to the extent that, the enhancement in value represented enhancement in value of the real estate, and not upon the ground that it represented the value of the building separated from the real estate (p. 468). Hence, all that seems left of the *Blatt* case is the uncertainty of future receipt. This seems eliminated here by specific provision of the lease that the property will be surrendered at the end of the term in "good state and condition" as they now are (ordinary wear and tear and damage by the elements or fire excepted)." (R. 35–36.)

It is in this light that we have felt that this Court might hold that under the facts of this case taxpayer realized income in 1946, and, hence, our contention that the income was realized in that year is an alternative to the contention that the income was realized in 1952.

E. Enhanced value attributable to the improvements

The Tax Court did not make any finding with respect to the value attributable to the building either in 1946 or in 1952. If this Court should reverse the Tax Court and hold that the value of the building represented rent for either of these years, we submit that this case should be remanded to the Tax Court to determine the proper amount to be included as rental income.

CONCLUSION

The decision of the Tax Court is wrong and should be reversed by this Court, and this case should be remanded to the Tax Court for further proceedings to determine the amount of rental income received under the lease.

Respectfully submitted,

CHARLES K. RICE,
Assistant Attorney General.
LEE A. JACKSON,
A. F. PRESCOTT,
KARL SCHMEIDLER,
Attorneys,
Department of Justice,
Washington 25, D. C.

APRIL 1958.

APPENDIX

TABLE OF EXHIBITS PURSUANT TO RULE 18 (2) (F) AS AMENDED

Exhibits	Set forth in printed record	Identified, offered and received
1–A	R. 67–70	R. 92
2–B	R. 70–72	R. 92
3–C	R. 73–75	R. 92
4–D	R. 76–79	R. 92

U. S. GOVERNMENT PRINTING OFFICE: 1958